

SEC



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**ANNUAL AUDITED REPORT  
FORM X-17A-5  
PART III**

SEC FILE NUMBER  
8-25976

FACING PAGE

**Information Required of Brokers and Dealers Pursuant to Section 17 of the  
Securities Exchange Act of 1934 and Rule 17a-5 Thereunder**

REPORT FOR THE PERIOD BEGINNING 01/01/05 AND ENDING 12/31/05  
MM/DD/YY MM/DD/YY

**A. REGISTRANT IDENTIFICATION**

NAME OF BROKER-DEALER: KDC Merger Arbitrage Fund, LP

OFFICIAL USE ONLY

ADDRESS OF PRINCIPAL PLACE OF BUSINESS: (Do not use P.O. Box No.)

FIRM I.D. NO.

900 Third Avenue - Suite 1000

(No. and Street)

New York  
(City)

NY  
(State)

10022  
(Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT IN REGARD TO THIS REPORT

(Area Code - Telephone Number)

**B. ACCOUNTANT IDENTIFICATION**

INDEPENDENT PUBLIC ACCOUNTANT whose opinion is contained in this Report\*

PricewaterhouseCoopers, LLP

(Name - if individual, state last, first, middle name)

300 Madison Avenue  
(Address)

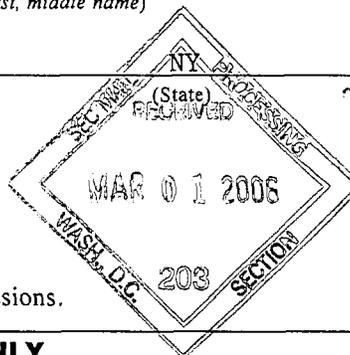
New York  
(City)

10017  
(Zip Code)

CHECK ONE:

- Certified Public Accountant
- Public Accountant
- Accountant not resident in United States or any of its possessions.

PROCESSED  
MAY 30 2006  
THOMSON  
FINANCIAL



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\*Claims for exemption from the requirement that the annual report be covered by the opinion of an independent public accountant must be supported by a statement of facts and circumstances relied on as the basis for the exemption. See Section 240.17a-5(e)(2)

SEC 1410 (06-02)

Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

OATH OR AFFIRMATION

I, Glen M. Friedman, swear (or affirm) that, to the best of my knowledge and belief the accompanying financial statement and supporting schedules pertaining to the firm of KDC Merger Arbitrage Fund, LP, as of December 31, 2005, are true and correct. I further swear (or affirm) that neither the company nor any partner, proprietor, principal officer or director has any proprietary interest in any account classified solely as that of a customer, except as follows:

No Exceptions



Karen L. Bauer  
Notary Public

Signature

Chief Financial Officer

Title

This report \*\* contains (check all applicable boxes):

- (a) Facing Page.
- (b) Statement of Financial Condition.
- (c) Statement of Income (Loss).
- (d) Statement of Changes in Financial Condition.
- (e) Statement of Changes in Stockholders' Equity or Partners' or Sole Proprietors' Capital.
- (f) Statement of Changes in Liabilities Subordinated to Claims of Creditors.
- (g) Computation of Net Capital.
- (h) Computation for Determination of Reserve Requirements Pursuant to Rule 15c3-3.
- (i) Information Relating to the Possession or Control Requirements Under Rule 15c3-3.
- (j) A Reconciliation, including appropriate explanation of the Computation of Net Capital Under Rule 15c3-1 and the Computation for Determination of the Reserve Requirements Under Exhibit A of Rule 15c3-3.
- (k) A Reconciliation between the audited and unaudited Statements of Financial Condition with respect to methods of consolidation.
- (l) An Oath or Affirmation.
- (m) A copy of the SIPC Supplemental Report.
- (n) A report describing any material inadequacies found to exist or found to have existed since the date of the previous audit.

\*\*For conditions of confidential treatment of certain portions of this filing, see section 240.17a-5(e)(3).

**KDC Merger Arbitrage  
Fund, LP**

Statement of Financial Condition  
December 31, 2005

**KDC Merger Arbitrage Fund, LP**

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**December 31, 2005**

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PricewaterhouseCoopers LLP  
PricewaterhouseCoopers Center  
300 Madison Avenue  
New York NY 10017  
Telephone (646) 471 3000  
Facsimile (813) 286 6000

**Report of Independent Auditors**

To the Partners of KDC Merger Arbitrage Fund, LP

In our opinion, the accompanying statement of financial condition, including the condensed schedule of investments, presents fairly, in all material respects, the financial position of KDC Merger Arbitrage Fund, LP (the "Partnership") at December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. This financial statement is the responsibility of the Partnership's management. Our responsibility is to express an opinion on this financial statement based on our audit. We conducted our audit of this statement in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

*PricewaterhouseCoopers LLP*

February 27, 2006

**KDC Merger Arbitrage Fund, LP**  
**Statement of Financial Condition**  
**December 31, 2005**

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<b>Assets</b>		
Cash		\$ 4,426,086
Securities owned, at fair value		
Securities owned	\$ 583,928,312	
Securities owned, held by clearing broker	<u>6,197,790</u>	
		590,126,102
Unrealized gain on contracts for differences, at fair value		153,290
Receivable from brokers, dealers and clearing organizations		1,792,809,612
Dividends receivable		141,602
Furniture and equipment, at cost, net of accumulated depreciation of \$1,564,137		295,124
Other assets		<u>1,399,077</u>
Total assets		<u>\$ 2,389,350,893</u>
<b>Liabilities and Partners' Capital</b>		
<b>Liabilities</b>		
Bank loans		\$ 10,000
Securities sold, but not yet purchased, at fair value		445,047,172
Payable to brokers, dealers and clearing organizations		1,786,695,275
Dividends payable		98,592
Contribution received in advance		250,000
Withdrawals payable		46,676,944
Other liabilities		<u>2,866,400</u>
Total liabilities		<u>2,281,644,383</u>
Partners' capital		<u>107,706,510</u>
Total liabilities and partners' capital		<u>\$ 2,389,350,893</u>

The accompanying notes are an integral part of this financial statement.

**KDC Merger Arbitrage Fund, LP**  
**Condensed Schedule of Investments**  
**December 31, 2005**

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
<b>Securities Owned</b>			
<b>Common Stocks</b>			
<b>United States</b>			
	Appliances	\$ 3,764,000	3.50%
	Application Software	4,100,250	3.81%
	Banks		
452,104	Bank of America Corporation	20,864,600	19.37%
183,740	Citigroup Inc.	8,916,902	8.28%
103,500	Comerica Inc.	5,874,660	5.45%
200,000	Hudson United Bancorp	8,336,000	7.74%
329,670	JPMorgan Chase & Co.	13,084,602	12.15%
	Other	8,528,000	7.92%
	Broadcasting		
456,000	Clear Channel Communications Inc.	14,341,200	13.32%
	Casino Services	4,509,270	4.19%
	Computers and Computer Services		
100,000	Anteon International Corporation	5,435,000	5.05%
	Other	1,388,000	1.29%
	Dialysis Centers		
200,000	Renal Care Group Inc.	9,462,000	8.78%
	Finance		
550,000	MBNA Corporation	14,932,500	13.86%
225,000	WestCorp	14,987,250	13.91%
	Other	1,903,750	1.77%
	Food - Dairy Products		
167,310	Dean Foods Company	6,300,895	5.85%
	Footwear		
102,000	Reebok International Ltd.	5,939,460	5.51%
	Insurance		
227,500	Jefferson Pilot Corporation	12,951,575	12.02%
	Other	3,551,000	3.30%
	Medical/Pharmaceutical		
166,500	AmerisourceBergen Corporation	6,893,100	6.40%
325,000	Guidant Corporation	21,043,750	19.54%
175,000	Inamed Corporation	15,344,000	14.25%
225,000	IVAX Corporation	7,049,250	6.54%
563,402	Johnson & Johnson	33,860,460	31.44%
1,945,000	Pfizer Inc.	45,357,400	42.11%
	Military Electronics		
250,000	Engineered Support Systems Inc.	10,410,000	9.67%
	Multimedia		
234,630	Viacom Inc. Class B	7,648,938	7.10%
	Other	4,360,000	4.05%

**KDC Merger Arbitrage Fund, LP**  
**Condensed Schedule of Investments**  
**December 31, 2005**

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
	<b>Common Stocks, continued</b>		
	Nursing Homes	\$ 4,084,500	3.79%
	Oil Exploration & Production		
150,000	Burlington Resources Inc.	12,930,000	12.00%
1,078,000	ChevronTexaco Corporation	61,198,059	56.82%
800,000	ConocoPhillips	46,544,000	43.21%
200,000	Vintage Petroleum Inc.	10,666,000	9.90%
	Paper Products	3,490,080	3.24%
	Real Estate Investment Trust		
200,000	Arden Realty Inc.	8,966,000	8.32%
200,000	Centerpoint Properties Trust	9,896,000	9.19%
346,889	Equity Office Properties Trust	10,521,143	9.77%
126,584	Prologis	5,914,004	5.49%
	Retail - Apparel	951,500	0.88%
	Telecommunications Service & Equipment		
603,750	Motorola Inc.	13,638,713	12.66%
304,100	Nextel Partners Inc.	8,496,554	7.89%
325,000	Telewest Global Inc.	7,741,500	7.19%
	Other	1,871,596	1.74%
	Therapeutics	1,611,750	1.50%
	Utility		
149,265	FirstEnergy Corporation	7,312,492	6.79%
	Other	5,265,040	4.89%
	Total United States (cost \$540,228,128)	<u>542,236,743</u>	<u>503.44%</u>
	<b>Bermuda</b>		
	Diversified Manufacturing		
580,874	Tyco International Ltd. (cost \$26,578,189)	16,764,024	15.56%
	<b>Canada</b>		
	Retail - Department Store (cost \$776,171)	773,590	0.72%
	<b>Germany</b>		
	Telecommunications Service & Equipment		
646,138	Deutsche Telekom AG (cost \$9,304,396)	10,745,275	9.98%
	<b>United Kingdom</b>		
	Telecommunications Service & Equipment		
861,000	Vodafone Group Plc (cost \$29,419,552)	18,485,670	17.16%
	Total common stocks (cost \$606,306,436)	<u>\$ 589,005,302</u>	<u>546.86%</u>

**KDC Merger Arbitrage Fund, LP**  
**Condensed Schedule of Investments**  
**December 31, 2005**

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
<b>Exchange Traded Equity Options</b>			
<b>United States</b>			
Footwear			
730	Reebok International Ltd. Jan. 2006 50 Call	\$ 609,550	0.56%
	Lottery Services	75,000	0.07%
Medical Instruments			
500	Guidant Corporation Jan. 2006 65 Call	103,750	0.10%
	Telecommunications	332,500	0.31%
	Total exchange traded equity options (cost \$1,127,444)	<u>1,120,800</u>	<u>1.04%</u>
	Total securities owned (cost \$607,433,880)	<u>\$ 590,126,102</u>	<u>547.90%</u>

**KDC Merger Arbitrage Fund, LP**  
**Condensed Schedule of Investments**  
**December 31, 2005**

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
<b>Securities Sold, but Not Yet Purchased</b>			
<b>Common Stocks</b>			
<b>United States</b>			
	Aerospace/Defense Equipment	\$ (1,554,787)	(1.44)%
	Banks		
(727,380)	Bank of America Corporation	(33,568,587)	(31.17)%
(183,740)	Citigroup Inc.	(8,916,902)	(8.28)%
(103,500)	Comerica Inc.	(5,874,660)	(5.44)%
(329,700)	JPMorgan Chase & Co.	(13,085,793)	(12.15)%
(323,478)	Wachovia Corporation	(17,099,047)	(15.88)%
	Other	(4,209,113)	(3.91)%
	Broadcasting		
(456,000)	Clear Channel Communications Inc.	(14,341,200)	(13.32)%
	Casino Services	(4,509,270)	(4.19)%
	Computers	(1,480,219)	(1.37)%
	Food - Dairy Products		
(167,260)	Dean Foods Company	(6,299,012)	(5.85)%
	Insurance		
(188,596)	Lincoln National Corporation	(10,001,246)	(9.29)%
	Medical/Pharmaceutical		
(81,824)	Allergan Inc.	(8,833,719)	(8.20)%
(166,500)	AmerisourceBergen Corporation	(6,893,100)	(6.40)%
(563,402)	Johnson & Johnson	(33,860,460)	(31.44)%
(1,945,000)	Pfizer Inc.	(45,357,400)	(42.11)%
	Other	(4,100,444)	(3.81)%
	Multimedia		
(234,651)	Viacom Inc. Class B	(7,649,623)	(7.10)%
	Oil - Integrated		
(1,078,028)	ChevronTexaco Corporation	(61,199,650)	(56.82)%
(908,248)	ConocoPhillips	(52,841,869)	(49.06)%
(84,000)	Occidental Petroleum Corporation	(6,709,920)	(6.23)%
	Paper Products	(3,490,080)	(3.24)%
	Real Estate Investment Trust		
(346,906)	Equity Office Properties Trust	(10,521,659)	(9.77)%
(126,591)	Prologis	(5,914,331)	(5.49)%
	Telecommunications Service & Equipment		
(603,789)	Motorola Inc.	(13,639,593)	(12.66)%
	Other	(4,415,675)	(4.10)%
	Utility		
(149,265)	FirstEnergy Corporation	(7,312,492)	(6.79)%
	Other	(5,310,450)	(4.93)%
	Total United States (proceeds \$415,804,613)	<u>\$ (398,990,301)</u>	<u>(370.44)%</u>

**KDC Merger Arbitrage Fund, LP**  
**Condensed Schedule of Investments**  
**December 31, 2005**

Shares, No. of Contracts or Principal Amount	Description	Fair Value	Percent of Partners' Capital
	<b>Common Stocks, continued</b>		
	<b>Bermuda</b>		
	Diversified Manufacturing		
(580,897)	Tyco International Ltd. (proceeds \$27,014,365)	\$ (16,764,687)	(15.57)%
	<b>Germany</b>		
	Telecommunications Service & Equipment		
(645,987)	Deutsche Telekom AG (proceeds \$10,211,846)	(10,742,764)	(9.97)%
	<b>United Kingdom</b>		
	Telecommunications Service & Equipment		
(861,000)	Vodafone Group Plc (proceeds \$33,495,573)	<u>(18,485,670)</u>	<u>(17.16)%</u>
	Total common stocks (proceeds \$486,526,397)	(444,983,422)	(413.14)%
	<b>Exchange Traded Equity Options</b>		
	<b>United States</b>		
	Lottery Services	(7,500)	(0.01)%
	Telecommunications Service & Equipment	<u>(56,250)</u>	<u>(0.05)%</u>
	Total exchange traded equity options (proceeds \$127,500)	<u>(63,750)</u>	<u>(0.06)%</u>
	Total securities sold, but not yet purchased (proceeds \$486,653,897)	<u>\$ (445,047,172)</u>	<u>(413.20)%</u>
	<b>Contracts for Differences</b>		
	Canada	\$ 17,825	0.02%
	United Kingdom	<u>135,465</u>	<u>0.12%</u>
	Total contracts for differences	<u>\$ 153,290</u>	<u>0.14%</u>

The accompanying notes are an integral part of this financial statement.

**KDC Merger Arbitrage Fund, LP**  
**Notes to Statement of Financial Condition**  
**December 31, 2005**

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**1. Organization and Activities**

KDC Merger Arbitrage Fund, LP (the "Partnership", formerly known as Kellner, DiLeo & Co.), a Delaware limited partnership formed on March 12, 1981, is registered as a broker-dealer under Federal and New York State securities laws and as an investment adviser under the Investment Advisers Act of 1940. The Partnership engages in risk arbitrage investing (i.e., investing in the securities of public companies which are the subjects of announced mergers) and the related trading of securities and options.

Kellner DiLeo Cohen & Co., LLC is the General Partner of the Partnership.

**2. Significant Accounting Policies**

**Basis of Presentation**

The Partnership's records are maintained on the accrual basis of accounting and conform to accounting principles generally accepted in the United States of America.

**Securities Transactions**

Financial instruments, including options, are recorded at fair value. Purchases and sales of financial instruments are recorded on a trade-date basis. Dividends on securities owned and on securities sold, but not yet purchased, are recognized on the ex-dividend date.

Securities which are listed on a national securities exchange are valued by the Partnership at their last sale price on the date of valuation, or, if no sales occurred on that date, at the mean "bid" and "asked" prices on that date. Securities which are not listed are valued by the General Partner at their last closing "bid" price if held "long" and last closing "asked" price if held "short." Investments for which quotations are not readily available or whose quotes are deemed to be inappropriate by the General Partner, are valued at estimated fair value as determined in good faith by the General Partner, based on, among other things, the type of investment or underlying investment, marketability (or absence thereof), cost and quotations from outside brokers. The fair value of financial instruments determined by the General Partner is based upon available information and is not necessarily indicative of an amount that the Partnership could realize in a current transaction. Because of the inherent uncertainty of valuation for these investments, the estimated fair value may not necessarily represent amounts that might be ultimately realized, since such amounts depend on future circumstances, and the difference could be material.

**Securities Lending Activities**

Securities borrowed and securities loaned are carried at the amount of cash collateral advanced or received. The Partnership monitors the market value of securities borrowed and loaned on a daily basis with additional collateral obtained or refunded as necessary.

**Foreign Currency Translation**

The accounts of the Partnership are maintained in U.S. dollars. Assets and liabilities denominated in non-U.S. dollar currencies are translated into U.S. dollar equivalents using year-end spot foreign currency exchange rates.

**KDC Merger Arbitrage Fund, LP**  
**Notes to Statement of Financial Condition**  
**December 31, 2005**

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**Fixed Assets**

Depreciation of furniture and fixtures is computed by using the straight-line method over the estimated useful lives of the related assets (generally seven years). Computer equipment is depreciated over five years. Communications equipment is depreciated over ten years.

**Withdrawals Payable**

The Partnership changed its method of recognizing withdrawals in 2005 in conjunction with its adoption of FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity, as effected by FASB Staff Position No. FAS 150-3. Withdrawals are recognized as liabilities, net of incentive allocation, when the amount requested in the withdrawal notice becomes fixed. This generally may occur either at the time of the receipt of the notice, or on the last day of a fiscal period, depending on the nature of the request. As a result, withdrawals paid after the end of the year, but based upon year-end capital balances are reflected as withdrawals payable at December 31, 2005. Withdrawal notices received for which the dollar amount is not fixed remains in capital until the amount is determined. Withdrawals payable may be treated as capital for purposes of allocations of gains (losses) pursuant to the Partnership's governing documents.

**Income Taxes**

No provision for federal, state, and local income taxes has been made as individual partners are responsible for their own tax payments on their proportionate share of the Partnership's taxable income.

**Clearing Agreement**

The Partnership clears certain of its securities through a clearing broker on a fully disclosed basis. Pursuant to the terms of the agreement between the Partnership and the clearing broker, the clearing broker has the right to charge the Partnership for losses that result from a counterparty's failure to fulfill its contractual obligations. As the right to charge the Partnership has no maximum amount and applies to all trades executed through the clearing broker, the Partnership believes that there is no determinable amount assignable to this right. At December 31, 2005, the Partnership has recorded no liabilities with regard to this right.

In addition, the Partnership has the right to pursue collection or performance from the counterparties who do not perform their contractual obligations. The Partnership monitors the credit standings of the clearing broker and all counterparties with which it conducts business.

**Use of Estimates and Indemnifications**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of this financial statement. Actual results could differ from those estimates.

In the normal course of business, the Partnership enters into contracts that contain a variety of representations and warranties and which provide general indemnifications. The Partnership's maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against the Partnership that have not yet occurred. However, based on experience, the Partnership expects the risk of loss to be remote.

**KDC Merger Arbitrage Fund, LP**  
**Notes to Statement of Financial Condition**  
**December 31, 2005**

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**3. Receivable from and Payable to Brokers, Dealers and Clearing Organizations**

Amounts receivable from and payable to brokers, dealers and clearing organizations at December 31, 2005 consist of the following:

Securities borrowed	\$ 1,780,815,272
Other amounts due from brokers, dealers and clearing organizations	<u>11,994,340</u>
Total receivable	<u>\$ 1,792,809,612</u>
Securities loaned	\$ 1,781,848,011
Other amounts payable to brokers, dealers and clearing organizations	<u>4,847,264</u>
Total payable	<u>\$ 1,786,695,275</u>

**4. Securities Owned and Securities Sold, but Not Yet Purchased**

Under SFAS 140, securities owned which can be resold or re-hypothecated by the holder have been reclassified on the statement of financial condition to securities owned and held by clearing broker.

Securities sold, but not yet purchased, represent obligations of the Partnership to deliver specified securities at the contracted prices and thereby create a liability to repurchase the securities in the market at prevailing prices. Accordingly, these transactions result in off-balance sheet market risk, as the Partnership's ultimate obligation to satisfy securities sold, but not yet purchased, may exceed the amount recognized in the financial statements.

The Partnership has loaned to brokers and dealers, securities having a market value of \$1,712,550,750. In addition, the Partnership has borrowed from brokers and dealers, securities having a market value of \$1,716,186,965.

**5. Bank Loans**

Bank loans at December 31, 2005 consist of demand loans of \$10,000, which bear interest at a rate of 5.125%. Such loans are fully collateralized by certain of the Partnership's marketable securities which are valued at \$3,359,350 on December 31, 2005.

**KDC Merger Arbitrage Fund, LP**  
**Notes to Statement of Financial Condition**  
**December 31, 2005**

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**6. Financial Instruments**

The Partnership enters into transactions in derivative financial instruments with varying degrees of off-balance sheet risk as part of its normal proprietary trading activities and in order to reduce its exposure to market risk in connection with these activities. The values of these instruments are a function of the underlying securities values and volatilities and interest rates. These transactions include the purchases and sales of equity option contracts. A buyer of an option has the right to purchase (in the case of a call option) or sell (in the case of a put option) a specified quantity of a specific financial instrument at a specified price prior to or on a specified expiration date. A writer of an option is exposed to the risk of loss if the market price of the underlying financial instrument declines (in the case of a put option) or increases (in the case of a call option). A writer of a call option can never profit by more than the premium paid by the buyer, but can lose an unlimited amount.

The Partnership may enter into contracts for differences ("CFD's") as part of its investment strategies. A CFD is an agreement between two parties to exchange the difference between the opening price and the closing price of an underlying security, at the close of the contract, multiplied by the number of shares specified within the contract. Such transactions are stated at fair value and are subject to margin and collateral requirements as stipulated by the counterparty. Net unrealized gains are reported as an asset and net unrealized losses are reported as a liability on the statement of financial condition.

A summary of the fair value of the Partnership's derivative financial instruments follows:

	<u>Fair Value as of December 31, 2005</u>	
	<u>Long</u>	<u>Short</u>
Equity options	\$ 1,120,800	\$ (63,750)
Contracts for differences	\$ 153,290	\$ -

The majority of the Partnership's transactions relate to trading in quoted securities on national securities exchanges with a diverse group of corporate and institutional counterparties. The securities loaned and securities borrowed transactions are collateralized and executed with major domestic and international brokers and dealers. The Partnership's exposure to credit risk associated with the nonperformance of these counterparties in fulfilling their contractual obligations for such transactions can be directly impacted by a volatile trading market which may impair the counterparties' ability to satisfy their obligations to the Partnership. Securities loaned and securities borrowed transactions are entered into to facilitate the trading operations and as part of a conduit business. Exposure is monitored on a daily basis, with additional collateral obtained or refunded as necessary.

**KDC Merger Arbitrage Fund, LP**  
**Notes to Statement of Financial Condition**  
**December 31, 2005**

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**7. Commitments and Contingencies**

The Partnership is obligated under a lease commitment for its office space, which expires on December 31, 2009. The lease contains provisions for operating and tax escalations based on increased costs by the lessor. The minimum rental commitment under this lease at December 31, 2005 is as follows:

2006	\$ 487,408
2007	487,408
2008	487,408
2009	487,408
	<u>\$ 1,949,632</u>

At December 31, 2005, the Partnership is contingently liable for letters of credit aggregating \$1,443,750, \$370,000 of which are collateralized by \$1,842,436 of the Partnership's marketable securities. Such letters of credit are primarily used to satisfy margin deposits at clearing organizations. In addition, at December 31, 2005, the Partnership had approximately \$20.9 million of securities owned, which have been pledged as collateral with a clearing organization to satisfy margin deposits.

**8. Related Party Transactions**

In the normal course of business, the Partnership pays certain expenses on behalf of its affiliated entities. The timing and payment of these amounts periodically causes payables and receivables between the Partnership and the affiliated entities.

The Partnership serves as the investment advisor to certain affiliated entities. The Partnership receives a management fee at the rate of 1.5% per annum, payable in arrears, based on the net asset value of the limited partner accounts of such affiliated entities.

The Partnership also provides administrative services to certain affiliated entities. The Partnership is reimbursed for all expenses incurred in connection with the provision of services to such affiliated entities. As stipulated in the Partnership's service agreement, the Partnership receives a monthly fee based upon the net assets of the affiliated entities.

At December 31, 2005, approximately \$42.2 million of partners' capital is owned or controlled by members or affiliates of the General Partner. Of this amount, approximately \$30 million relates to an investment by a partnership organized and managed by the General Partner, where substantially all the limited partners are unaffiliated investors.

Other assets at December 31, 2005 includes receivable from affiliated entities and management and administrative fees receivable totaling \$905,797.

Withdrawals payable as of December 31, 2005 include \$1,160,745 payable to the General Partner.

Other liabilities includes a note payable to a member of the General Partner of approximately \$900,000 at an interest rate of 4.125% at December 31, 2005.

**9. Net Capital Requirements**

The Partnership is subject to the Securities and Exchange Commission's Uniform Net Capital Rule (Rule 15c3-1 or "the Rule"), which requires the maintenance of minimum net capital. The Partnership has elected to use the alternative method permitted by the Rule, which requires that it maintain minimum net capital, as defined, of \$250,000. The Partnership has net capital of \$60,401,457 at December 31, 2005, which exceeds requirements by \$60,151,457.

Anticipated partners' capital withdrawals of approximately \$11.8 million are expected within the six months following December 31, 2005.

The Partnership claims exemption under the exemptive provisions of the Securities and Exchange Commission's Rule 15c3-3 pursuant to paragraph (k)(2)(i), since it maintains no customer accounts.

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**Report of Independent Auditors on Internal  
Control Required by SEC Rule 17a-5**

To the Partners of KDC Merger Arbitrage Fund, LP

In planning and performing our audit of the financial statements and supplemental schedule of KDC Merger Arbitrage Fund, LP (the "Partnership") for the year ended December 31, 2005, we considered its internal control, including control activities for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (the "SEC"), we have made a study of the practices and procedures followed by the Partnership, including tests of compliance with such practices and procedures, that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:

1. Making the periodic computations of aggregate indebtedness and net capital under Rule 17a-3(a)(11);
2. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13; and
3. Determining compliance with the exemptive provisions of Rule 15c3-3.

Because the Partnership does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Partnership in any of the following:

1. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System; and
2. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3.

The management of the Partnership is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs

of control and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve the SEC's above-mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Partnership has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control or the practices and procedures referred to above, errors or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of internal control would not necessarily disclose all matters in internal control that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the specific internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving internal control, including procedures for safeguarding customer and Partnership assets, including securities, that we consider to be material weaknesses as defined above.

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934, and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Partnership's practices and procedures were adequate at December 31, 2005 to meet the SEC's objectives.

This report is intended solely for the information and use of the partners, management, the SEC, the National Association of Securities Dealers, Inc., and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934, in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

*PriceWaterhouseCoopers LLP*

February 27, 2006